

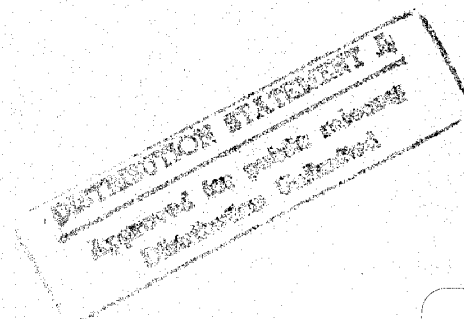
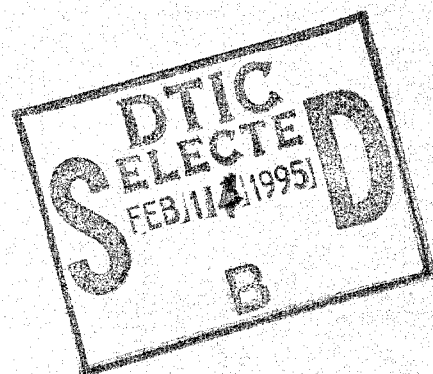
GAO

Briefing Report to the Honorable  
Bruce A. Vento, House of Representatives

February 1992

# RESOLUTION TRUST CORPORATION

## Assessing Portfolio Sales Using Participating Cash Flow Mortgages



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## General Government Division

B-247628

February 25, 1992

The Honorable Bruce F. Vento  
House of Representatives

Dear Mr. Vento:

This briefing report responds to your June 1991 request for us to review the Resolution Trust Corporation's (RTC) pilot program of portfolio sales using participating cash flow mortgages. We briefed your office on the results of this work on February 4, 1992. This briefing report contains the information we presented.

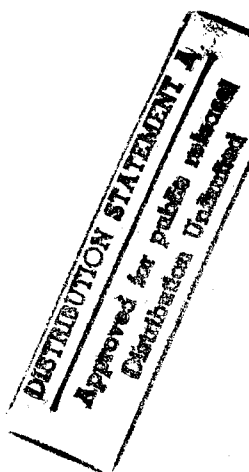
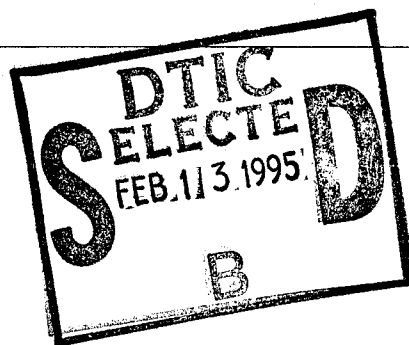
BACKGROUND

RTC was created to manage and dispose of the assets of insolvent thrifts. As of September 30, 1991, it held an inventory of assets totaling about \$147 billion. Commercial real estate and land totaled about \$15.7 billion of the inventory. These two categories include some of RTC's hardest-to-sell assets.

RTC sells real estate assets using a variety of methods, including individual sales, auctions, and portfolio sales. Portfolio sales can be structured using cash, RTC seller financing, or other more flexible financing terms. This report will focus on portfolio sales using participating cash flow mortgages. Cash flow mortgages are financing structures in which the principal and interest payments (debt service) are determined by cash flow generated from the financed asset. They may also have a participating structure in which the lender and the borrower share in the cash flow and sales proceeds.

RESULTS IN BRIEF

RTC faces a major challenge in attempting to dispose of less desirable real estate assets in a depressed market. The large current inventory and expected future additions will require RTC to develop creative and innovative strategies. We believe that, in concept, the use of portfolio sales using participating cash flow mortgages could be an important disposition strategy for RTC's least marketable real estate assets and reflects RTC's willingness to become more innovative and market responsive. We also believe that, overall, the strengths of the pilot portfolio sales using participating cash flow mortgages outweigh the weaknesses.



However, we also believe that additional actions are necessary to improve the implementation of the pilot portfolio sales and to aid in future transactions. In this regard we are recommending that RTC perform a post-closing assessment of the pilot transactions. Moreover, portfolio sales using participating cash flow mortgages require diligent post-closing monitoring and administration in order to protect RTC's long-term interests. In this context, a centralized oversight process should be implemented prior to the completion of the pilot transactions. To this end, we are also recommending that RTC develop detailed oversight procedures for loan monitoring and administration, centralize oversight responsibility, and implement an oversight process in a timely manner. Finally, we are recommending that the RTC resolve loan accounting issues which arise from the pilot transactions. (See app. I p. 41)

#### OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to

- assess the overall structure and implementation of RTC's pilot program of real estate portfolio sales using participating cash flow mortgages; and
- analyze at least three specific transactions in order to assess whether the disposition of RTC assets using this strategy was fair, reasonable, and economical.

To address these objectives we reviewed RTC's Offering Portfolios of Assets for Sale Policy, Marketing of Asset Portfolios Policy, and Seller Financing Policy and Guidelines. We examined case presentations, financial analysis, and contract documents for the three pilot transactions with Patriot American Investors, Tishman Portfolio Partners, and General Electric Capital Corporation. We also reviewed the opinions of an independent financial advisor and an independent underwriter.

We interviewed RTC National Sales Center staff responsible for negotiating the participating cash flow mortgage transactions. We met with RTC's in-house and outside legal counsel and asset valuation contractor representatives. We also interviewed RTC management to gain information on RTC's plans for future oversight of portfolio sales using participating cash flow mortgages.

We did our work in Washington, D.C., between July 1991 and November 1991 in accordance with generally accepted government auditing standards.

AGENCY COMMENTS

We discussed the contents of this report with the RTC staff responsible for the negotiation and oversight of the pilot portfolio sales. They generally agreed with the information, conclusions, and recommendations. Their comments have been incorporated into this report where appropriate.

On January 17, 1992, an RTC official informed us that RTC does not anticipate the Tishman and General Electric transactions will move forward as originally negotiated. The official said the RTC does not believe they have sufficient inventory to fulfill the requirements of the transactions. According to the official, RTC will structure portfolios of office buildings for competitive bidding.

As agreed with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 10 days from the date of this letter. At that time, we will send copies of this report to the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Thrift Depositor Protection Oversight Board of the Resolution Trust Corporation, the Chief Executive Officer of the Resolution Trust Corporation, and interested congressional committees. We will also make copies available to others upon request.

This report was prepared under the direction of Ronald L. King, Assistant Director, Federal Management Issues. Other major contributors are listed in appendix IV. If you have any questions about this report, please call me at (202) 736-0479.

Sincerely yours,

*Gaston L. Gianni*  
Gaston L. Gianni, Jr.

Associate Director,  
Federal Management Issues

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ASSESSING PORTFOLIO SALES USING  
PARTICIPATING CASH FLOW MORTGAGES

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## Objectives, Scope, and Methodology

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- Assess structure and implementation of pilot
- Review three transactions
  - Tishman Portfolio Partners
  - Patriot American Investors
  - General Electric Capital Corp.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to assess the overall structure and implementation of RTC's pilot program of real estate portfolio sales using participating cash flow mortgages and to analyze at least three specific transactions, in order to assess whether the disposition of RTC assets using this strategy was fair, reasonable, and economical.

To accomplish our objectives, we reviewed RTC's Offering Portfolios of Assets for Sale Policy, Marketing of Asset Portfolios Policy, and the RTC Seller Financing Policy and Guidelines. We reviewed the case presentations, financial analysis, and contract documents for the three pilot transactions. In addition, we reviewed the opinion of an independent financial advisor on the three pilot transactions and the independent underwriter's opinion on the transaction with Patriot American Investors.

We interviewed RTC National Sales Center staff responsible for the participating cash flow mortgage transactions, RTC's in-house and outside legal counsel, and asset valuation contractor representatives. We also met with RTC management to gain information about RTC's plans for future oversight of portfolio sales using participating cash flow mortgages.

At the time of our review, RTC had negotiated three pilot portfolio sales using participating cash flow mortgages. One master sales agreement, with Patriot American Investors, was signed in August 1991. Two remaining transactions, involving Tishman Portfolio Partners and General Electric Capital Corporation (GE), were pending when this report was prepared.

During the course of our work, several issues arose concerning the pilot transaction with Patriot American Investors. Questions were raised about the implementation of the Patriot transaction, including the selection and qualification of assets and the coordination between the RTC National Sales Center and Regional and Consolidated Offices. In October 1991, the RTC Inspector General was asked to address these issues by the RTC Oversight Board. As a result, we excluded these issues from our review.

The Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives issued a staff study in December 1991 on the transaction with Patriot American Investors. This study raises policy and implementation issues specific to the Patriot transaction. Our study evaluates RTC's policy for portfolio sales using participating cash flow mortgages and the three pilot transactions. We did not address implementation issues specific to the Patriot transaction.



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## RTC Inventory and Sales as of September 30, 1991

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- Inventory
    - \$147 billion - total assets
    - \$ 45 billion - hard to sell
    - \$ 15.7 billion - commercial real estate and land
  
  - Sales
    - \$ 4.4 billion - commercial real estate and land
    - 28 percent of inventory
-

RTC INVENTORY AND SALES

As of September 30, 1991, RTC held \$147 billion inventory of assets from failed thrifts. Of this total, about \$45 billion were hard-to-sell assets, including delinquent loans and real estate. Commercial real estate and land accounted for about \$15.7 billion, or 35 percent of RTC's hard-to-sell assets. Portfolio sales are used to sell RTC's hard-to-sell assets. The assets selected for sale in the pilot cash flow transactions included commercial real estate, such as office buildings and retail and hotel properties.

As of September 30, 1991, RTC had sold \$6.2 billion of real estate assets, including \$4.4 billion of commercial real estate and land. Sales of commercial real estate and land totaled about 28 percent of the inventory of these types of assets.

On the basis of past experience, RTC is likely to see an increase in its commercial real estate inventory because of the distressed economy. An excess of supply over demand and other economic factors have resulted in asset devaluation, a dramatic increase in foreclosures, and additional thrift failures across the nation.

The commercial real estate inventory is one of RTC's hardest to sell asset categories. In the past, RTC has had difficulty selling commercial real estate for several reasons. RTC's commercial real estate inventory includes many distressed and underperforming assets. Most of RTC's commercial real estate is of lower quality than properties of other institutional sellers, such as life insurance companies, banks, and pension funds. Further, the majority of RTC's commercial property inventory is believed to be only partially occupied. For example, RTC officials believe the average occupancy rate for RTC-owned office buildings is around 50 to 60 percent.

When we initiated this study, RTC had experienced limited interest in its real estate assets, especially from major/institutional investors for large quantities of RTC properties. Many investors are reluctant to purchase assets because their values may continue to decline. Investors are also reluctant to purchase lower quality assets when higher quality assets are readily available.

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## Market Environment for Commercial Real Estate

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- Abundant supply
- Values declining in some areas
- Limited financing sources

MARKET ENVIRONMENT FOR COMMERCIAL REAL ESTATE

The current soft market for commercial real estate poses many challenges to RTC. RTC must sell its large inventory of commercial real estate assets in a market with an abundant supply of assets, declining asset values in some areas, and limited sources of financing.

An abundant supply of distressed commercial assets is on the market. In addition to the assets offered by RTC, many large institutional investors such as life insurance companies and commercial banks are divesting large quantities of commercial real estate which was overbuilt in the 1980s when capital was readily available.

Asset values are declining in some areas. A large oversupply of space in conjunction with a decrease in demand has resulted in lower rents for commercial assets, and the average length of time required to lease commercial properties has increased. These factors have had an adverse effect on the financial performance of existing assets which, in turn, has led to reduced asset values and an overall devaluation of the market. The abundance of assets on the market further decreases asset values. In areas where asset values are declining, investors are hesitant to purchase properties.

Limited financing sources are available for purchases of commercial real estate assets. During the 1980s, financing from thrifts, commercial banks, insurance companies, and other institutional lenders was readily available for commercial assets. Today, however, traditional real estate financing sources have been drastically curtailed. Many lenders are returning to more conservative underwriting policies. New regulatory requirements for higher capital levels are currently discouraging lenders from making new commercial real estate loans.

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## RTC Portfolio Sales Policy

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- Increase sales of assets
  - Emphasize large-volume sales (\$100 million or more)
  - Contracts may be negotiated
  - Offer financing to qualified purchasers
  - Maximize net present value return
-

RTC PORTFOLIO SALES POLICY

In May 1991, the RTC Board of Directors approved a policy statement entitled "Offering Portfolios of Assets For Sale." Its purpose was to increase RTC's sales of large quantities of assets through negotiations with qualified purchasers and to give RTC an additional cost effective approach to selling RTC assets. Also, the Board approved three negotiated portfolio sales of commercial real estate properties and instructed staff to resubmit the terms of each transaction before finalizing.

The policy states that RTC may solicit, evaluate, and negotiate purchase offers for portfolio sales of qualified assets. Portfolio sales are generally asset sales of at least \$100 million under one transaction. Qualified assets include real estate, delinquent loans, and other illiquid assets. The assets to be included in portfolio sales may be identified in advance or selected after contract negotiation.

RTC may offer specific types of financing to qualified purchasers who have been evaluated by an independent advisor on their financial capability and asset management experience. Financing can include methods in conformance with RTC's seller-financing policy (see p. 17) or participating cash flow financing. With the latter financing, RTC holds the first lien on the asset and payments are made from the cash flow generated by the property. RTC will participate in asset appreciation upon sale or refinancing.

The portfolio sales policy requires RTC to maximize its net present value return on the portfolio of widely marketed assets. An individual asset may be sold for a price below the minimum acceptable sales price provided that the total net present value return to RTC for the entire portfolio exceeds the sum of the minimum acceptable sales prices for each asset.

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## RTC "Marketing of Asset Portfolios" Policy

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- Portfolio Sales Policy revised
  - Authorized pilot sales of up to \$8 billion
  - National Sales Center responsible for sales
  - Two new marketing programs
  - Use of financial advisors
-

RTC "MARKETING OF ASSET PORTFOLIOS" POLICY

In September 1991, the RTC Board of Directors approved a revised portfolio sales policy statement entitled "Marketing of Asset Portfolios." The revised policy statement includes changes as requested by the RTC Oversight Board. The Marketing of Asset Portfolios Policy states that RTC, through the National Sales Center, may solicit, evaluate, and competitively select purchase offers for portfolios of qualified assets on a pilot basis. Pilot program sales of up to \$8 billion were authorized.

The Marketing of Asset Portfolios Policy states that RTC regional and consolidated field offices or RTC asset management contractors may initiate portfolio sales transactions in cooperation with the National Sales Center. However, the National Sales Center will have primary responsibility to negotiate the offers and oversee the portfolio sales process.

The revised policy highlights two new marketing programs. One is a competitive solicitation program where, on the basis of market preferences, RTC assembles a portfolio of assets and solicits investors' purchase offers. RTC then selects the most attractive proposals and negotiates the final contract terms. The second program is the "widely marketed" portfolio program where RTC considers purchase offers for portfolios of assets "widely marketed" by RTC for at least 6 months and selected by the investor. RTC negotiates the final contract terms.

The revised policy permits RTC to retain the services of an independent financial advisor. The advisor may assist in proposal evaluation, asset valuation, due diligence, buyer underwriting and qualification assessment, and other duties. However, RTC continues to make all major decisions.



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## RTC Seller-Financing Policy

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- Accelerate illiquid asset sales and increase recovery
  - Funding of \$7 B with \$250 M for single-family affordable housing
  - Identifies specific criteria and financing terms
  - Promotes sales of seller-financed loans
-

RTC SELLER-FINANCING POLICY

RTC addressed seller financing in its December 1989 Strategic Plan. RTC was to use seller financing only when necessary to complete real estate transactions to ensure the maximum net present value to RTC. The policy has been amended several times. The latest revision was approved by the RTC Oversight Board in June 1991. RTC established seller-financing guidelines for implementing the latest policy in January 1992.

The goals of seller financing are to accelerate the pace of illiquid asset sales and to increase RTC's net present value recovery on assets. RTC policy permits it to provide up to \$7 billion of seller financing, with no less than \$250 million reserved for single-family affordable housing. As of September 30, 1991, RTC had a total of about \$257 million in outstanding loans under the seller-financing program.

The most recent RTC policy statement outlines specific criteria for providing seller financing. It will be provided for those illiquid assets that are not readily marketable due to a lack of available commercial financing on acceptable terms. It must also be determined that financing will provide a higher net present value return to RTC than other alternatives.

The seller-financing policy identifies financing terms to be required. The buyer must provide a down payment of not less than 15 percent of the purchase price, possibly including a funded escrow, letter of credit, or other suitable collateral. The policy states that RTC is to obtain a lien on all financed assets with the priority of the lien determined by RTC. In addition, the policy also states that the terms of the financing should be arranged so that RTC shares in operating cash flow and asset appreciation.

The policy statement approved by the Oversight Board directs RTC to develop and implement a program to promote the timely sale of seller-financed loans through appropriate means, including private placements and public offerings. An earlier version of the policy required that RTC determine at the time of the loan origination that the loan could be resold within 1 year. The most recent guidelines state that RTC should attempt to sell any seller-financed loan in a timely and cost-effective manner. They also suggest that it is desirable for RTC to structure these loans so that they can be sold in the secondary market.

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## Participating Cash Flow Mortgage Characteristics

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- Debt service determined by cash flow
  - Cash flow and future sales proceeds shared by lender and buyer
  - Used when flexible debt structures needed
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PARTICIPATING CASH FLOW MORTGAGE CHARACTERISTICS

Cash flow mortgages are financing structures in which the principal and interest payments (debt service) are determined by cash flow generated from the financed asset. In other words, principal and interest payments are made only from the asset's operating cash flow. Generally, the borrower is not obligated to pay debt service until positive cash flow is generated from the asset. In more traditional financing structures, the borrower is obligated to make principal and interest payments even if an asset is losing money. Additionally, if a borrower is unable to pay the full debt service, the lender may foreclose and take control of the asset. Cash flow financing enables the borrower to pay debt service out of the cash flow from the asset and gives the borrower greater flexibility to improve asset performance.

Cash flow mortgages may also have a participating structure. Under this structure, the lender and the borrower share in the asset's cash flow on a predetermined basis. Upon asset sale or refinancing, the lender and the borrower also share in the proceeds on a predetermined basis. (See app. II for a hypothetical example of a participating cash flow structure.)

Cash flow mortgages have been used by institutional lenders, such as insurance companies and pension funds, in situations when flexible debt structures are required. For example, cash flow financing can be used when the cash flow from an asset is uncertain due to market conditions. It can also be used in situations where the asset requires additional investments to enhance occupancy levels and increase rental rates. These investments include funding of operating deficits and tenant improvements. In addition, lenders have used cash flow mortgages as a loan restructuring or work-out mechanism.

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## Current Portfolio Sales

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- Status of transactions
    - Contract signed with Patriot
    - Two transactions pending
  - Negotiated transactions
    - Discussions with investors
    - RTC states negotiated in competitive environment
  - Similar transaction terms
-

CURRENT PORTFOLIO SALES

RTC has negotiated three portfolio sales using participating cash flow mortgages. In August 1991, RTC signed a Master Agreement of Sale with Patriot American Investors. Patriot agreed to purchase \$300 to \$500 million of office buildings and hotels. RTC and Patriot are still negotiating the selection and qualification of assets to be included in the sale. RTC has also negotiated preliminary terms with Tishman Portfolio Partners and General Electric Capital Corporation for office buildings, shopping centers, and industrial properties of about \$600 million.

RTC reported that the three negotiated transactions resulted from RTC discussions with about 30 large investors. RTC officials said portfolio sales using participating cash flow mortgages were discussed during these meetings. According to RTC officials, RTC solicited and received numerous proposals from the investors after receiving a proposal from Patriot. An RTC official said the proposals from Patriot, Tishman, and GE were the only proposals for office buildings that included widely marketed properties and negative cash flow properties. These were the types of properties RTC was prepared to sell using participating cash flow mortgages. RTC reported that the three transactions were negotiated in a competitive environment with the intent that only one offer would be submitted to the RTC Board of Directors for approval. However, all three were submitted for approval because they resulted in comparable economic returns to RTC.

The participating cash flow financing terms of all three transactions are similar. For example, the properties included in each sale are to be "widely marketed" by RTC for at least six months or unsuccessfully offered in a sealed bid or other organized marketing program. The properties are to be purchased at prices that reflect estimated current market value as determined by an independent contractor. In addition, properties with negative cash flow are to be included in all three buyer's portfolios. For example, 25 percent of the office buildings and 20 percent of the hotels purchased by Patriot must be properties with negative cash flow.

Through the participating cash flow financing terms of these transactions, RTC is to participate in the annual cash flows and any future sales proceeds. Each transaction requires a down payment and a funded escrow account. The transactions require a down payment of 15 percent of the purchase price for properties with positive cash flow and at least a 5 percent down payment for negative cash flow properties. All three require a funded escrow for the first year's capital improvements. The escrow may also include leasing costs, operating deficits, and/or tenant improvements.

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## Current Portfolio Sales (continued)

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- Asset valuation method
    - Discounted cash flow valuation
    - Performed by advisor
  - Reasonableness review by independent advisor
  - Underwriter review
  - Transaction stages
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CURRENT PORTFOLIO SALES (continued)

The buyers will pay 100 percent of the estimated value of the property based on a valuation performed by a third party advisor. The valuation methodology determines individual asset value by discounting projected cash flows from operations and proceeds from sale or refinancing to a net present value. This method of analysis is similar to other valuation methods used to determine investment real estate asset values. Additionally, the expected present value return to RTC from each transaction is to exceed the sum of the minimum acceptable sales prices for each individual asset.

RTC received the opinion of an independent financial advisor on the reasonableness and appropriateness of each transaction. The advisor also evaluated the pros and cons of each transaction and the safeguards to RTC. The general opinion of this advisor was that overall, the transactions were reasonable and appropriate and that the overall strengths of the transactions outweighed the weaknesses. However, the advisor stated that RTC should carefully evaluate the weaknesses in determining whether to complete the transactions.

RTC will contract with an independent underwriter to evaluate the financial and ownership/management capabilities of the prospective buyers. The final sales agreements are contingent on a favorable report from the underwriter. RTC has received the underwriter's report on the transaction with Patriot American Investors. The underwriter gave a favorable recommendation as to the ability of the borrowing entities to perform in the transaction. The report also stated that the positive attributes of the transaction overshadow the negative attributes.

After the Master Sales Agreement is signed by RTC and the purchaser, the transactions are to proceed through a series of stages including asset selection and qualification, asset valuation, due diligence and inspection, and the closing of individual asset sales. (See app. III for a summary of the transaction stages.)



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## Current Portfolio Sales (continued)

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- Asset selection process varies
    - Patriot selection process
    - Rotational selection process
  - Oversight process currently being developed
  - Portfolio sales emphasized as disposition strategy
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CURRENT PORTFOLIO SALES (continued)

The asset selection process varies for the three pilot transactions. In the Patriot transaction, the buyer provides RTC with a written list of certain properties that it believes are qualified properties. An independent contractor, retained by RTC, gathers information on the listed properties. Using this information, RTC determines if the properties are qualified. For this transaction, qualified properties include office buildings and hotels that RTC is legally permitted to sell and that have been unsuccessfully marketed for at least 6 months or offered in an unsuccessful disposition program. Patriot may purchase any asset on the list that has been qualified for the transaction in order to fulfill the portfolio mix required by the terms of the agreement. Patriot may provide RTC with no more than two supplemental lists every 30 days until the asset requirements of the transaction are met.

In the event that RTC determines the properties on Patriot's lists are not sufficient to satisfy the minimum requirements of the transaction, RTC has two options. First, RTC may provide Patriot with a list of qualified properties from which Patriot is required to select sufficient properties to fulfill the transaction requirements. Second, RTC may modify the minimum transaction requirements.

The Tishman and General Electric transactions will include a rotational selection process. Under this process, both RTC and the buyer are to nominate assets to be included in the transactions. On a rotating basis, RTC and the buyer are to select assets from those nominated until all eligible assets have been selected or until the minimum requirements of the transaction have been met.

RTC officials stated that the oversight process for portfolio sales is currently being developed. RTC has received recommendations from two outside consultants regarding oversight requirements of the transactions. RTC officials said they will be soliciting loan servicers and asset managers for the transactions. They said their goal is to have an oversight program for the participating cash flow mortgages in place by late spring 1992.

RTC has been placing increased emphasis on portfolio sales as a major disposition strategy. Recently, RTC regional offices and asset management contractors have been active in structuring such sales. It is unclear if these sales will involve cash, traditional financing methods, or participating cash flow financing.

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## Strengths

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- Should facilitate sale of large amounts of properties in distressed markets
  - Have potential to be more cost effective and timely than single asset sales
  - Give RTC up-front cash and interest in future cash flows and profits
-

STRENGTHS

Portfolio sales should facilitate the disposition of large dollar amounts of widely marketed properties in distressed markets. RTC officials said that investors who have the ability to purchase portfolios of RTC assets seek greater input into the selection of properties included in each portfolio. In the past, RTC sales of real estate have been slow. RTC officials stated that since the announcement of this program, buyers have expressed greater interest in RTC properties.

Portfolio sales should be more timely and cost effective than single asset sales, allowing RTC to take advantage of economies of scale in large transactions. This type of sale is most effective for those assets that would require a longer liquidation period, such as distressed commercial, retail, and hotel properties. RTC incurs management, administrative, and maintenance costs when holding these types of assets and is at risk for further asset devaluation. This approach should also reduce the length of time RTC manages property, thereby reducing holding costs.

Portfolio sales using participating cash flow mortgages enable RTC to receive up-front cash while retaining an interest in future cash flows and profits. Using cash flow financing, RTC should be able to sell assets in a distressed market. In addition, RTC will participate in future asset appreciation if asset performance improves. On the other hand, if asset values decline and cause the buyer to default on the loan, or if the buyer defaults for other reasons, RTC can foreclose because it holds the first lien on the asset. If this occurs, RTC would still have gained the buyer's equity investment, saved on holding costs, gained on any improvements made by the buyer, and, possibly, obtained a share of cash flow.

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## Strengths (continued)

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- May be preferable to holding assets under SAMDA contracts
  - Should enhance buyer's performance and future asset values
  - Transfers liability to buyer
  - Limits management fees
-

STRENGTHS (continued)

RTC may find that portfolio sales using participating cash flow mortgages are preferable to holding assets under Standard Asset Management and Disposition Agreement (SAMDA) contracts. Under the pilot transactions, the buyer has equity at risk in the property and is motivated to maximize the value of the property. In addition, the management fees earned by the buyer are limited. The SAMDA contractor earns a management fee, a disposition fee, and an incentive disposition fee. In April 1991, RTC modified SAMDA in order to enhance the contractor's incentives to sell assets quickly and at higher prices. RTC wants to encourage asset sales, not asset management. Portfolio sales lessen RTC's financial burden and administrative costs because the buyer is required to cover operating expenses and capital expenditures. Under a SAMDA contract, RTC must compensate the contractor for the costs of maintaining the assets. Finally, portfolio sales using participating cash flow mortgages generally remove RTC's future liability associated with property ownership while RTC remains liable for those properties under SAMDA contracts.

The structure of portfolio sales using participating cash flow mortgages should enhance the buyer's performance and future values of the properties. Since the buyer has risked equity in the down payment and the capital improvements escrow, the buyer has a financial stake in the performance of the property. The buyer also shares in the cash flow generated from the property, and the buyer's cash investment is repaid on the basis of that cash flow. Also, since the buyer shares in the profit from a property sale, he has a direct interest in the quality of property management and leasing, which affects the property's future value.

The buyer assumes liability associated with ownership of the property under participating cash flow mortgages. RTC shares in the profits of a property without being subject to any of these associated liabilities.

In the pilot portfolio sales we reviewed, RTC limits the property management fees that the buyer may earn on the portfolio of assets. In addition, the buyer is not entitled to any other asset management, development, or supervisory fees. In the Patriot transaction, the management fees for office buildings are limited to an amount that is reasonable and customary for the market in which the property is located, not to exceed 5 percent of gross income. With respect to hotel properties, the fees are reasonable and customary for the local hotel market, not to exceed 6 percent of gross income.

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## Strengths (continued)

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- RTC can foreclose if buyer is not diligent
  - RTC receives reports on property performance and annual audits
  - Buyer is to fund operating deficits
  - Procedures exist to release capital improvements escrow
-

STRENGTHS (continued)

In the three pilot transactions we reviewed, RTC can foreclose on a property if the buyer is not diligent in its leasing or management efforts or fails to meet its loan obligations. RTC's return on investment is dependent on the quality of the property leasing and management. If RTC determines that the purchaser has not made diligent attempts to lease or manage the property, RTC can foreclose and sell the property to another buyer. However, determining whether the buyer has made diligent efforts to effectively manage and lease the property will require strong RTC oversight performed by qualified staff with specialized skills and market expertise.

After the pilot transactions have been closed, RTC and the loan servicer will receive quarterly reports on property performance and annual audits prepared by third-party auditors. These documents should help enable RTC to monitor the performance of the property and the asset purchaser.

In the agreement signed with Patriot, the buyer is to fund operating deficits of the property. Patriot is required to fund a capital improvement reserve that consists of the projected tenant improvements, deferred maintenance, capital improvements, and, for negative cash flow properties, operating deficits for the first 12 months following the closing of the transaction. The improvement reserve should be no less than 10 percent of the purchase price for negative cash flow properties.

In the agreement signed with Patriot, specific procedures must be followed for the release of funds from the capital improvements escrow which should ensure the availability of cash for the first year's capital improvements and operating deficits. This is an additional protection so that, even if the property does not produce net operating income, the funds should be available to make the necessary improvements and to cover operating deficits during the first year of the mortgage. Before funds are released to the buyer from the escrow fund, the buyer must submit reasonable evidence of the operating deficit or improvement costs for RTC approval. In addition, RTC has the right to inspect the property to ensure that improvements are being completed as necessary.



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## Weaknesses

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- Return to RTC uncertain due to market factors
  - Requires diligent monitoring and oversight
  - Buyer receives investment back at a rate greater than RTC receives principal
-

WEAKNESSES

RTC's present value return on the pilot transactions is uncertain due to variable market conditions and other factors. RTC is to share in the cash flow of the property and is to receive a portion of the proceeds when the asset is sold. RTC's present value return depends on the performance of the property and the property manager. If the property performs poorly, this return will be less than expected. Conversely, if the property performs well, the return will be better than anticipated.

The pilot portfolio sales using participating cash flow mortgages will require diligent post-closing monitoring and oversight to avoid potential waste, fraud, and abuse. Centralized oversight procedures should help enable RTC to diligently monitor and oversee these transactions. These transactions have extensive compliance and reporting requirements that require the continuing attention of RTC to ensure that the transaction agreements are fully carried out. Otherwise, the taxpayer's interests may not be fully protected, and RTC may not achieve its expected return.

In the three pilot transactions we reviewed, the buyer will receive its investment (escrow and down payment) back at a rate greater than RTC receives its principal. This provision reduces the buyer's financial exposure relative to RTC's exposure early in the transaction. In the three pilot transactions, RTC is providing financing of at least 85 percent of the purchase price. However, RTC will receive less than 85 percent of the portfolio's cash flow until the buyer's investment is repaid. After the buyers are reimbursed for their investment, in two of the three pilot transactions, RTC receives less than 85 percent of the cash flow. (See app. II for a hypothetical example of a participating cash flow structure.) Because of these payment priorities, the buyers will recover their capital investment at a faster rate than RTC will receive principal on its loan.

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## Weaknesses (continued)

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- Buyer may abandon poorly performing assets
  - Maturity dates of transactions extend beyond life of RTC
  - Loans may be unsuitable for sale on the secondary market
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WEAKNESSES (continued)

In the pilot portfolio sales using participating cash flow mortgages, RTC faces the risk that the buyer may abandon poorly performing assets and keep the assets that are performing well. Because each asset is purchased under a separate note and mortgage, the buyer can return individual assets without the risk of losing the other purchased assets. The return of an individual asset could generate additional losses when RTC resells the asset. However, the buyer's investment in the asset should act as an incentive to properly manage the property and improve its performance. The cash flow structure of the transactions should also reduce this risk because the buyer is not obligated to pay fixed debt service. Rather, payments are dependent upon the availability of cash flow.

The maturity dates of the transactions extend beyond the legislated life of RTC. These transactions were negotiated with terms of up to 12 years. Currently, RTC's legislated life continues until 1996. Thereafter, monitoring and oversight responsibilities will be assumed by the Federal Deposit Insurance Corporation.

The structure of the participating cash flow mortgages makes it unlikely that they can be sold on the secondary market. Also the loans are valued using an 11-percent discount rate to calculate RTC's net present value return. We believe, in agreement with the financial advisor, that this discount rate is below the yield the private market would require to purchase these loans if they were sold in the secondary market today.

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## Conclusions

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- Could be an important strategy to sell illiquid assets in current market environment
  - Innovative and market responsive
  - Overall, strengths outweigh weaknesses
  - Additional actions are necessary
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CONCLUSIONS

RTC faces a major challenge in attempting to dispose of less desirable real estate assets in a depressed market. RTC is also faced with intense competition as many other institutional sellers attempt to divest their commercial real estate portfolios. A large current inventory and expected future additions make it essential that RTC develop creative and innovative disposition strategies in order to dispose of its huge asset portfolio. In concept, we believe that portfolio sales using participating cash flow mortgages could be an important disposition strategy for hard-to-sell assets, especially RTC's least marketable real estate assets.

RTC needs to become more innovative and market responsive in its sales strategies. The pilot portfolio sales using participating cash flow mortgages demonstrate RTC's willingness to become more innovative and market responsive. We believe that portfolio sales using participating cash flow mortgages are a step in the right direction. National Sales Center officials indicated that buyers have expressed greater interest in RTC properties since the announcement of this program.

We believe that, overall, the strengths of the pilot portfolio sales using participating cash flow mortgages outweigh the weaknesses. This conclusion is shared by the independent financial advisor hired by RTC to examine each transaction and review the safeguards that benefit RTC. The advisor also stated that RTC should carefully evaluate the weaknesses in determining whether to complete the transactions.

As might be expected with any new program, RTC has experienced a number of implementation problems. We believe RTC needs to take additional actions in order to improve the implementation of the pilot portfolio sales using participating cash flow mortgages and to aid in future similar transactions. To improve the program, RTC should make an assessment of the pilot transactions once they are finalized in order to determine whether any changes should be made to future transactions. Such an evaluation should include whether RTC complied with the policy and transaction requirements, and if the transactions have the potential to meet RTC's financial objectives.

Portfolio sales using participating cash flow mortgages require diligent post-closing monitoring and administration in order to protect RTC's long-term interest. Therefore, centralized oversight policies and procedures should be implemented prior to the completion of the pilot transactions to help enable RTC to diligently monitor the completed pilot transactions.

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## Conclusions (continued)

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- Valuation method is reasonable
  - Financing terms should assist in selling distressed assets
  - Cash sales are preferable, but may not be achievable under today's market conditions
  - Accounting for loan assets should be determined
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CONCLUSIONS (continued)

We believe, in concurrence with the financial advisor, that the valuation method to be used in the pilot transactions to determine asset purchase price is reasonable. In addition, this method of analysis is similar to other valuation methods used to determine investment real estate asset values.

We believe that favorable financing terms, including participating cash flow mortgages, should assist in selling RTC's distressed commercial assets. The terms of these pilot transactions are probably better than any other financing available to the buyer; therefore, we believe portfolio sales should help RTC to dispose of its huge hard-to-sell asset portfolio.

Cash sales are preferable to RTC-financed transactions and should be pursued whenever possible. However, given the size of RTC's commercial portfolio, it is unclear if there are sufficient buyers with outside financing sources. Cash sales are preferred because they provide immediate cash to RTC with a certain net present value return. Financed transactions, however, require long-term funding from RTC's working capital account, and RTC's net present value return is subject to market and transaction risks. RTC may need to further discount prices in order to sell its hard-to-sell asset inventory if done solely through cash sales. This strategy would raise the issue of "dumping" and also require RTC to recognize additional losses above current estimates.

As previously stated, RTC uses a discount rate to calculate its net present value of the pilot cash flow transactions that we believe is below the yield requirement for a private market resale of the loans. In addition, RTC's net present value of the transactions is uncertain due to unknown future market conditions and property performance levels. Given these factors, RTC needs to determine how it will account for the loan assets that it receives as a result of the pilot transactions and whether an allowance for potential future loss is required.



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## Recommendations

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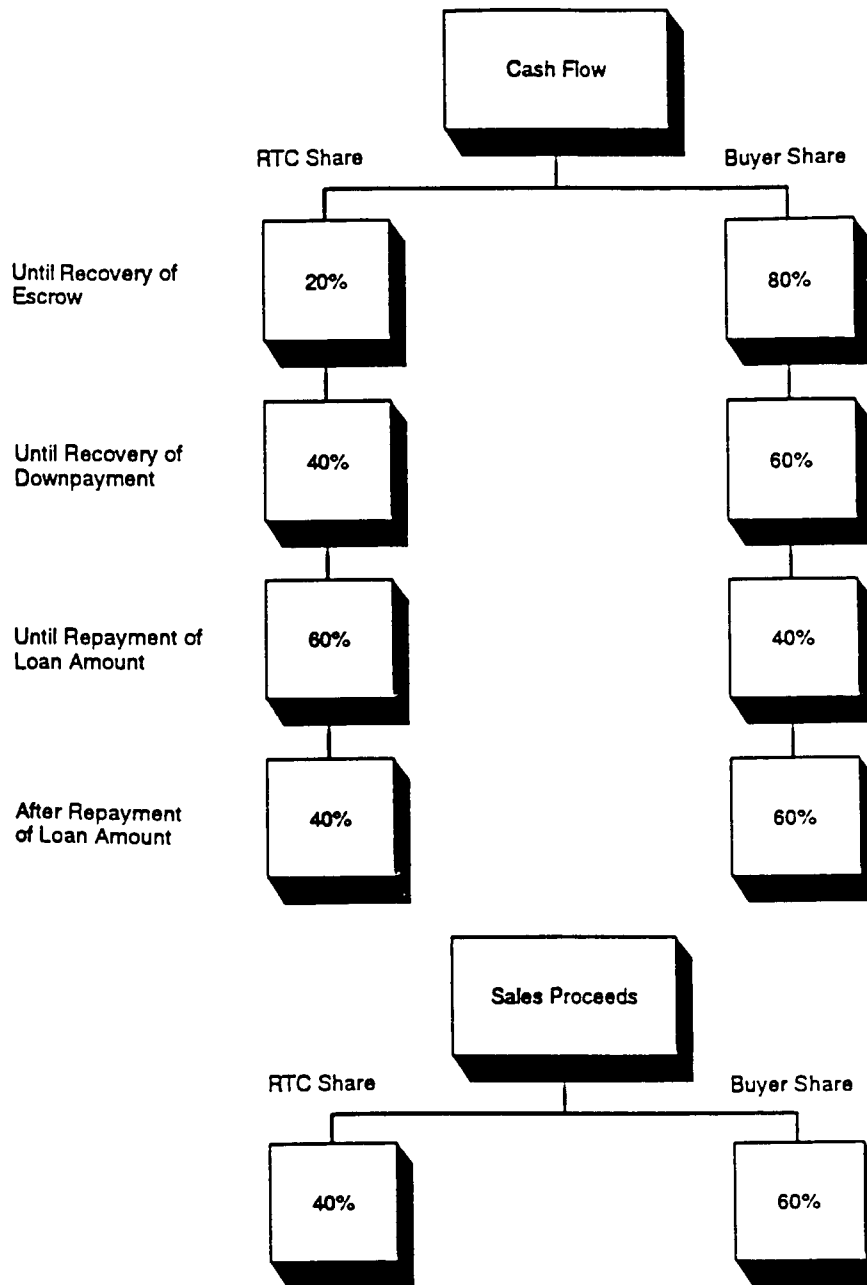
- Perform a post-closing assessment of the pilot transactions
  - Develop oversight procedures, centralize oversight responsibility, and implement an oversight process
  - Resolve loan accounting issues which arise from the pilot transactions
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RECOMMENDATIONS

We are making the following recommendations:

- RTC should perform a post-closing assessment of the pilot transactions to determine if all policy and transaction requirements were complied with and if the transactions have the potential to meet RTC's financial objectives.
- RTC should develop detailed oversight procedures for loan monitoring and administration, centralize oversight responsibility, and implement an oversight process in a timely manner. The oversight process should be implemented prior to the completion of the pilot transactions. These actions should enable RTC to closely monitor completed portfolio sales using participating cash flow mortgages in order to protect RTC's long-term interests.
- RTC should determine how it will account for the loan assets that it receives as a result of the pilot transactions and whether any allowance for potential future loss is required.

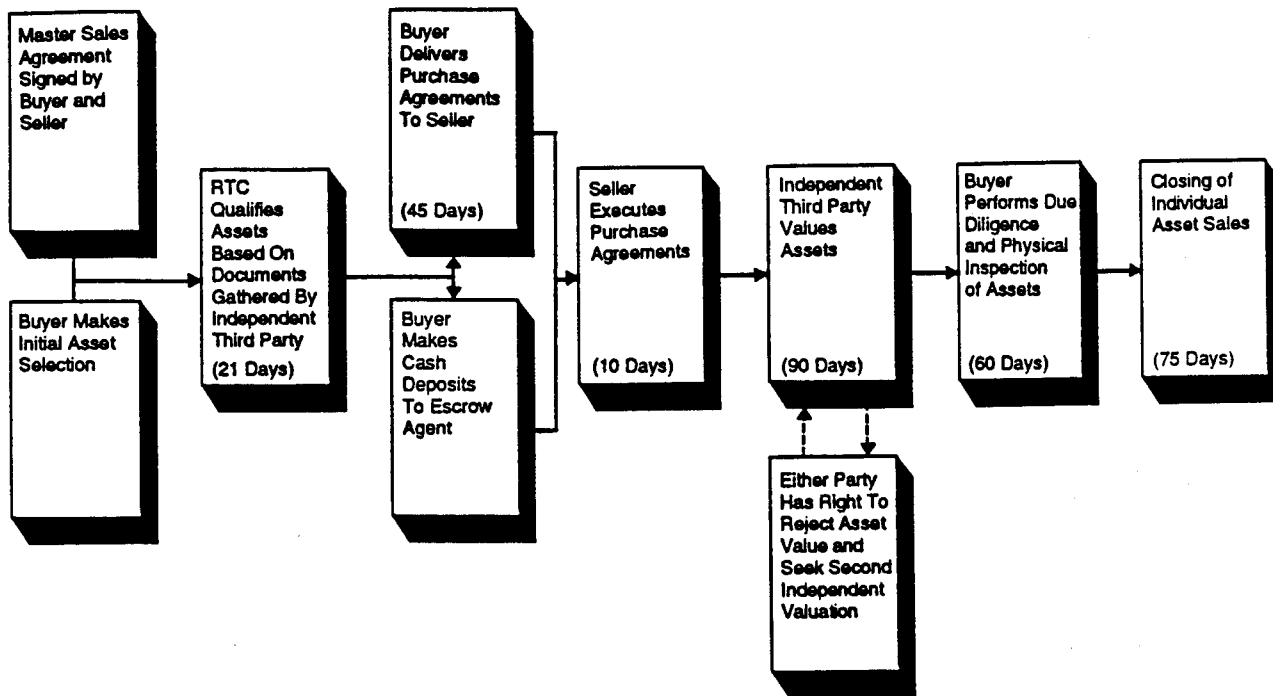
HYPOTHETICAL EXAMPLE OF A  
PARTICIPATING CASH FLOW STRUCTURE



Note: The hypothetical example is similar to the participating cash flow structures used in the three pilot transactions that we reviewed.

Source: GAO analysis of RTC data.

PORTFOLIO SALES WITH PARTICIPATING CASH FLOW MORTGAGES:  
SUMMARY OF TRANSACTION STAGES



Note: This information was developed from GAO's review of the pilot portfolio sale agreements between RTC and Patriot American Investors.

Source: GAO analysis of RTC data.

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